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No. 2524

United States

Circuit Court of Appeals

For the Ninth Circuit.

IDAHO-OREGON LIGHT AND POWER COMPANY, IDAHO RAILWAY, LIGHT & POWER COMPANY and O. G. F. MARKHUS, as Receiver of IDAHO RAILWAY, LIGHT & POWER COMPANY,

Appellants,

vs.

STATE BANK OF CHICAGO, BANKERS TRUST COMPANY, F. N. B. CLOSE, A. W. PRIEST, WILLIAM H. FORSTER, H. D. MILES, EDWARD J. MULLER, GEORGE E. FISHER, W. D. WILLARD, Personally and as a Bondholders Committee, W. J. FERRIS, as Receiver of IDAHO-OREGON LIGHT & POWER COMPANY, UNITED STATES OF AMERICA, IDAHO POWER & LIGHT COMPANY, GENERAL ELECTRIC COMPANY, WESTINGHOUSE ELECTRIC & MANUFACTURING COMPANY, A. H. SUNDLES and AMERICAN STEEL & WIRE COMPANY,

Appellees.

A. W. PRIEST, W. D. WILLARD, WM. H. FORSTER, H. D. MILES, EDWARD J. MULLER, GEORGE E. FISHER, D. M. LORD, JOHN R. ALLEN, W. O. CARRIER, ALLEN HOLLIS, CHARLES L. PARMELEE and CHARLES M. SMITH, Interveners, and Being a Protective Committee for the Holders of the First and Refunding Bonds of the IDAHO-OREGON LIGHT & POWER COMPANY,

Cross-Appellants,

vs.

IDAHO RAILWAY, LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver of IDAHO RAILWAY, LIGHT & POWER COMPANY, IDAHO-OREGON LIGHT & POWER COMPANY and W. J. FERRIS, Its Receiver, BANKERS TRUST COMPANY, F. N. B. CLOSE, UNITED STATES OF AMERICA, IDAHO POWER & LIGHT COMPANY, GENERAL ELECTRIC COMPANY, WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY, A. H. SUNDLES and AMERICAN STEEL & WIRE COMPANY,

Cross-Appellees.

BRIEF OF APPELLANTS AND CROSS-APPELLEES.

Upon Appeal and Cross-Appeal from the United States District Court for the District of Idaho, Southern Division.

CAVANAH, BLAKE & MACLANE,
Solicitors for Appellants.

JOHN F. MACLANE, *of Counsel.*

Filed
FEB 15 1915
F. D. Monckton,
Clerk.

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Cross-Appellees.

Answering Brief of Appellants and Cross-Appellees.

The appellees and cross-appellants have discussed their case in a single brief, filed as an answering brief, and assuming that the present record embraces, without distinction, and as applicable to both the appeal and cross-appeal, evidence excluded as well as that admitted and made the basis of the decree appealed from. To answer the brief, so far as it presents the cross-appeal, therefore, requires some reiteration of ground already covered.

It is probably unwise to try cases on stipulation, assuming the record to be other than it is, for such course is liable to lead, as it has done here, to disagreement as to the questions actually involved. The assumption on which the decree was entered, to which we consented and now consent, is set forth on page 49 of our original brief, and is commented upon on page 109 thereof. We did not feel, in so consenting, that we changed the issues as framed by the Court's order of September 19, 1913 (App. Brief, pp. 14–15; Record, pp. 55–59), nor opened a different theory, than that stated by the bill in intervention, for attacking the transactions in question. We assumed, and we think correctly, that the effect of the stipulation (which was made after the hearing) was to present the case as if (a) the proceeds of the sale were in court; (b) the Railway Company had presented its bonds—thus establishing *prima facie* its right to distribution; (c) the interveners had filed the bill here filed objecting to such distribution; (d) the court had framed the issues; (e) the Railway

Company had filed its present answer, and (f) the evidence here taken was before the court.

The issue thus framed is embraced in paragraph XIII of the bill in intervention, quoted on pages 12, 13 of our brief, in which it is alleged that the Railway Company being in control of the Power Company, procured from it 718 first mortgage bonds, in exchange for worthless second mortgage bonds, and therefore without consideration. This was the only issue which the Railway Company was required to meet, and it sought to meet it by showing: (a) that the bonds in question were available to the Power Company as against other bondholdlers for any lawful corporate purpose; (b) that the Power Company disposed of them by valid corporate action; (c) that if additional consideration to the surrender of second mortgage bonds were necessary, it was afforded by the advancement of $250,000, and by the settlement of the Bates and Rogers obligation of the Power Company.

The trial proceeded upon these lines. The Railway Company sought to establish the three propositions above stated. The interveners' evidence was all directed to the points that there was no valid corporate action, and that the bonds were not only available to the corporation, but were valuable corporate assets, and should have been sold for much more than the Railway Company paid for them, and, therefore, that their disposal to the Railway Company at the price paid by it was unauthorized and fraudulent as against the company, and that other bondholders

should have the same right to avoid the transaction, and on the same grounds, as the company.

1. The Question of Preference.

It is now urged that at the time of the questioned transactions, the Power Company was insolvent; that the transactions constituted a preference to the directors (through their interest in the Railway Company), and that the other bondholders as creditors are here in their own right avoiding such preference, or resisting its enforcement.

We do not think that this theory is properly before the court. It is not suggested either by the bill, the evidence or the decree, though it is mentioned in the reasoning of the District Judge in his memorandum decision. We refer to these briefly.

(a) *The Bill.*—A very brief summary of the bill is given on pages 10 to 14 of appellants' brief and it is discussed on pages 107, 108. It is set forth at length at pages 5 to 47 of the Record. Certainly the allegation on which the issues were framed contains no intimation that the Power Company was insolvent or that the issue of these bonds constituted a preference. But going beyond this, the other allegations of the bill negative any such theory, and in effect allege that the Power Company was in fact in prosperous circumstances, if it could but be divorced from the Railway Company and its assets collected. (Record, pp. 8, 18, 19, 33, 34, 39, 41, 42.)

(b) *The Evidence.*—No evidence was offered or received to show that the Power Company was insolvent in the fall of 1912. The only evidence which would tend to support such conclusion was the finan-

cial statements on pages 219 to 229 of the Record. These were admitted, not to show insolvency, but "for the purpose of showing the status of the business of the Idaho-Oregon Company as bearing upon the real value of the bonds" (p. 219). In so far as counsel touched upon this question otherwise, his testimony was directed to show that those bonds could have been marketed for a substantial sum, and if so marketed would have put the company on a sound basis. (Record, pp. 323–349; Appellee's Brief, pp. 115, 116.)

(c) *The Decree.*—The substance of the decree is given on pages 45 to 48 of appellant's brief. It is commented on at page 108, and it is sufficient to refer to what is there said, to show that the decree does not proceed upon any theory of insolvency and preference, but upon that of rescission of a fraudulent intercompany transaction.

(d) His Honor's decision, we think, was based upon what he knew of the present condition of the Power Company after it had been subjected for almost two years to drastic competition, and its estate had been involved for over a year in wasteful and disastrous litigation, which, if we may refer to excluded evidence frequently commented upon by the appellees, it was the purpose of the much criticised New York Committee to prevent.

(e) Appellees frequently refer to the "frank confessions" of insolvency and intent to prefer the Railway Company made by appellant's counsel. Isolated statements of the brief may be subject to such construction, but we do not think that is a fair construc-

tion of our brief or argument as a whole which is directed toward the establishment of the critical condition of the company in its need for funds, and the approaching competition, which if honestly disclosed would have rendered the first mortgage bonds unsalable in ordinary markets. The Railway Company was maintaining the Power Company as a going concern, intended so to do, and was willing to purchase its securities for that purpose. It could then be foreseen that it might become necessary to foreclose or adjust the second mortgage; events rendered it impossible to prevent foreclosure of the first.

We therefore submit that the question of preferential payment or security of a director is not really involved in the issues. For that reason it was not discussed in the opening brief.

But assume evidence of insolvency under appropriate issues, there is no question of *preference* presented. All that the Railway Company, or the alleged preferred directors, are seeking is *participation* in the distribution of assets which its, or their, money have added to the common security, and in which, by the terms of the instrument creating such security, they are entitled to participate. If by these transactions the directors obtained a preference over *other* creditors (which in the principal brief we have endeavored to show was not the case—pp. 130–136), let such creditors complain. What the appellees here are resisting is not preference but *participation,* which they agreed in their bonds and mortgage junior creditors might have.

But is it the law that directors of an insolvent or

failing corporation cannot prefer themselves? Two Circuit Court cases by Justice Woods, decided in the '80's during the vogue of the trust fund doctrine, are cited in support of this position.

The Supreme Court of the United States in *Hollins vs. Brierfield Coal etc. Co., 150 U. S. 371,* decided in 1893, explained and limited the trust fund doctrine, holding substantially that all that was meant thereby was that on winding up an insolvent corporation, its creditors are entitled to payment from its assets, in preference to stockholders. The Court said:

> "Whatever of trust there is arises from the peculiar and diverse equitable rights of the stockholders as against the corporation in its property and their conditional liability to its creditors. It is rather a trust in the administration of the assets after possession by a court of equity than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder."

See, also, *Fogg vs. Blair, 133 U. S. 534.*

The Circuit Court of Appeals for the Eighth Circuit has expressly held that it is "established by persuasive and controlling authority that the insolvency of a corporation does not *ipso facto* transform its assets into a trust fund for the equal benefit of its creditors. * * * Such being the law, it follows that an insolvent corporation may, in the exercise of its *jus dispondendi,* prefer one creditor to another." The Court then asks the question: "May it then prefer its own directors, if they happen to be creditors?"

And after careful discussion answers the question in the affirmative, so long as the debt is just.

American Exch. Bk. vs. Ward, 111 Fed. 782.

The Circuit Court of Appeals of the Sixth Circuit has reached the same conclusion.

Brown vs. Furniture Co., 58 Fed. 286.

In this case, the measure of the directors' duty is stated as follows: "The burden is on the preferred director of showing beyond question that he had a *bona fide* debt against the corporation." The Court further says: "Preferences are not based on any equitable principle. They go by favor, and as an individual may prefer, among his creditors, his friends and relatives, so a corporation may prefer its friends."

We also cite, as containing a very full and illuminating discussion of this question,

Corey vs. Wadsworth, 118 Ala. 488, 44 L. R. A. 766.

And we commend to the Court for a most careful analysis of this whole question, with the reasons for the opposing doctrines, the text of

Jones, Insolvent and Failing Corporations, pp. 141–160, secs. 126–134, inclusive.

We refer particularly to this work in lieu of further citation and discussion of primary authority, which we have not, at this writing, time to give.

2. *Avoidance and Rescission.*

Notwithstanding appellees' disclaimer—in view of the burdens which it would impose—of any succes-

sion to, or limitation by, the rights and duties of the corporation or stockholders, much of their brief is devoted to the question of avoidance of contracts between companies having common directors. The argument proceeds without difficulty, and in accordance with the doctrine announced in our brief, until the crucial point is reached in the assertion that a creditor may avoid such a contract on grounds available to the corporation or stockholders. (Appellees' Brief, pp. 99–104.) There it fails as a statement of what the law is, and becomes an essay as to what it should be, which, even as an essay, is inconvincing.

The cases cited have no relation to the subject.

In the case of *Washburne vs. Green,* the fraudulent director did not act under any form of corporate act or authority. He had no legal claim upon the bonds whatsoever. They were unissued bonds, for which no consideration had ever been given to the bondholders, in addition to property or otherwise, and the director, Richardson, attempted to procure title to them by a levy under an attachment. The Court held, being unissued, they were not subject to attachment, that Richardson acquired no title, and that by reason of his attempted fraud, he was not entitled to the rights of a salvor. The question of salvage is not involved in the case at bar at all.

Sweeney vs. Grape Sugar Company is the obvious case of a transfer to the controlling company of property otherwise available to the attacking creditor.

The case of *McGirky vs. Toledo R. Company* (cited p. 90) involves fraudulent car trusts, the participants in which endeavored to withdraw from the

operation of the after-acquired property clause of the mortgage cars and equipment which had been bought and paid for by the company. It was an attempted withdrawal of security from the mortgage. The mortgagee was the only person injured, and his injury was direct and apparent.

The true distinction is pointed out in *Mining Co. vs. Coosa Furnace Co.* (Appellants' Brief, pp. 80–82), where it is said that creditors are not entitled to disaffirm contracts on grounds available to the corporation or its stockholders, but that "The right of the creditor to impeach the transaction depends on its fraudulent character. The question in such case is, Was the transaction which is complained of entered into with intent to hinder, delay or defraud creditors?"

The question, then, of common directorate and constructive fraud inferred therefrom becomes immaterial under the law, and in view of appellees' apparent disclaimer of any derivative rights through the corporation, and we are reduced to the question of whether these transactions were actually fraudulent *against these interveners.* We are content with our argument on pages 85 to 106, 126–129, 136–137, of our principal brief, on this point.

3. Assuming the Voidable Character of the Issue of the Bonds, to What Extent are They Enforceable?

Here, we think, appellees join issue with us at the root of the case, and state their real position, and the position which, in one form or other, must be taken by the court to sustain any decree except that of full

ownership by the Railway Company of the questioned bonds. We call particular attention to pages 110 to 123, inclusive (subd. VIII) of appellees' brief, and some of the discussion at pages 123–132. There it is in substance asserted that these bonds are invalid against the other bondholders, represented by interveners, and cannot be enforced in any amount, except to the extent it is shown that the bondholders have been benefited, by additions to their security from the proceeds thereof.

If, on the other hand, these bonds so far belonged to the company as against the bondholders, by reason of the contract of mortgage and the considerations on which the bonds were certified, that the test or measure of their validity is benefit to the company and not to the bondholders, then it must follow that the bondholders have no interest in what the company got, and that the bonds are enforceable, except against objection by the company, or its privies, for their full face.

The principal brief of appellants maintains the affirmative of this latter proposition at length (see particularly, for summary, pp. 85–89), and we will not further discuss the question; except to say that appellees now come forth boldly, and assert that they are entitled to have their cake, and eat it too.

If, however, these bonds are to be condemned because they gave a preference, then they can only be condemned to the extent of such preference, that is, the excess of old consideration over new. The taking of security for the loan of $250,000 new money was not a preference, and could not be under any

theory. Such security would be good even under the bankruptcy act.

Taking the other theory—that of the learned District Judge—that of benefit to the company, in new consideration, is the test of the enforceability of the bonds, we are content with the argument made in the principal brief, which we think appellees have failed to meet. The Railway Company advanced $250,000, and committed itself to Bates and Rogers for $20,000 additional for these bonds, and such liability cannot be offset by any unsatisfied liability of Kissel-Kinnicutt and Company to buy second mortgage bonds.

Even were it assumed that the Railway Company had succeeded to this liability, the fact would not prevent it from advancing money on first mortgage bonds, before satisfying its obligation to buy seconds, nor is there any rule against the release of the obligation to buy seconds, and substitution therefor of an obligation to loan money on, or to buy, firsts.

4. *Errors in Evidence.*

The answers to cross-appellants' assignments of error on the exclusion of evidence are: (1) The offered evidence was not within the issues as framed, and there is no assignment of error directed to the order framing the issues. (2) The evidence was not competent. Courts uniformly refuse to concern themselves with reorganization schemes, and were the rule otherwise, no evidence was offered that the scheme was conceived prior to March, 1913, long after the transactions in question, nor that the scheme was proposed or authorized by the Railway Company.

Were such the case, there is nothing to show that

the reorganization plan was good or bad, beneficial or otherwise, conceived in inequity or the dream of a philanthropist. All that would appear would be that certain individuals, interested in the Railway and Power Companies, proposed to reorganize them on the basis of consolidation of the two.

Personally, we think the evidence shows that some form of consolidation was the only logical way to treat the situation, and the only way in which the investment of the bondholders of either company could be made good.

SUMMARY.

In view of the divergent arguments of the original, answering and reply briefs, it will be convenient to summarize our position as follows:

I. As a bill by the bondholder to rescind or annul fraudulent acts of directors, on grounds available to the company, the suit cannot be maintained,—because

1. The transactions were at most voidable, and creditors have no right to avoid them on grounds open to the company, viz.: (a) Want of proper corporate authorization; (b) common directorate; (c) lack of benefit to the company.

2. Neither the company, nor its stockholders, nor any person in privity with or succeeding to it or them was injured by the transactions.

3. The company, its privies and successors in interest, have ratified the transactions, or at least would now be estopped to avoid them.

II. As an objection by bondholders in their own right to distribution to alleged fraudulent bonds, on

the ground of preference to directors, the bill must fail, because—

1. The bondholders have expressly contracted for such use of the bonds, and have received the very consideration, upon which they could be so used.

2. There is no law against directors preferring themselves.

3. The interveners have not objected to the transaction on the ground of preference.

4. The issue of the bonds did not give preference, but participation.

III. In any event or view of the case, the appellants are entitled to hold the entire 718 bonds, for

1. $250,000 and interest.

2. $20,000, the commitment to Bates and Rogers.

Without in any way impugning the motives or good faith of counsel, we suggest that their brief fails to distinguish between allegation, proof and inference, and confuses evidence admitted and excluded, and we respectfully suggest a careful reading of the statement of the evidence as contained in the record.

We repeat, that we think the decree erroneous.

Respectfully submitted,

CAVANAH, BLAKE & MACLANE,

Solicitors for Appellants and Cross-Appellees.